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Client-Auditor Communications and the Privilege Doctrines: An Analysis of *United States v. Textron*

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In *U.S. v. Textron*,[1] the U.S. District Court for the District of Rhode Island protected tax accrual workpapers from forced disclosure to the IRS. The case provided an in depth discussion of the application of the attorney-client privilege and work-product doctrine to tax accrual workpapers. The court decided that while the attorney-client privilege did apply to such documents, the privilege was waived when the documents were disclosed to taxpayer's independent auditors. However, in a more controversial holding, the court concluded that the work-product doctrine protected the documents since they were ''prepared in anticipation of litigation'' under the court's definition of that requirement. Furthermore, work-product protection was not waived when the documents were disclosed to the independent auditor since the auditor's interests are not adverse to the taxpayer's interests.

Part I of this article provides the historical content in which this case was decided. Part II discusses the factual background of *U.S. v. Textron*. Part III surveys the relevant law concerning the attorney-client privilege and work-product doctrine. Part IV summarizes and analyzes the court's opinion in *Textron*.

I. Historical Context

Tax accrual workpapers typically consist of financial audit workpapers created by either the taxpayer or their agent that relate to the tax reserve for deferred tax liabilities. Frequently, in order to justify the reserve amount, the workpapers include an in-depth analysis of the tax issues involved in the transaction. The IRS has historically restrained itself from requesting taxpayers' tax accrual workpapers.[2] Only in rare circumstances has the IRS requested tax accrual workpapers.[3]

In 2002, however, the IRS changed their position by stating that it would routinely request the tax accrual workpapers for ''Listed Transactions'' as defined under Regs. §1.6011-4T(B)(2).[4] If the taxpayer had disclosed a listed transaction, the IRS stated that they would only request the tax accrual workpapers for the listed transaction itself.[5] However, if the transaction went undisclosed, the IRS stated that it would request all tax accrual workpapers from the taxpayer.[6] Chief Counsel Donald Korb recently summarized the IRS's position by stating that tax accrual workpapers are sought only

[1] *U.S. v. Textron, Inc.*, No. 06-198, 2007 WL 2458325 (D.R.I. Aug. 28, 2007).

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[2] *See* I.R.M. §4.10.20.2(2).
[3] *See, e.g., U.S. v. Arthur Young & Co.*, 465 U.S. 805 (1984).
[4] Announcement 2002-63, 2002-27 I.R.B. 72. The sale-in lease-out transactions conducted by Textron are listed transactions and thereby presumed by the IRS to be in violation of the tax laws.
[5] *Id.*
[6] *Id.*

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when the taxpayer has engaged in ''deals that the IRS thinks are not appropriate.''[7]

Simultaneous with the IRS's change in position, the political landscape surrounding auditing practices also changed. In the wake of corporate accounting scandals at such firms as Enron and Worldcom, auditors have increased their own standards for conducting audits. Under Section 10A of the 1934 Securities Exchange Act, independent auditors have long been required to follow ''procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct material effect on the determination of financial statement amounts.''[8] The result of this section has long led auditors to request privileged information relating to tax advice as well as non-tax documents. Recently, however, political pressures have led auditors to request privileged materials more often.[9]

Firms also are experiencing internal pressure due to the accounting requirements of the Financial Interpretation Number 48 (''FIN 48''). Under FIN 48, the Financial Accounting Standards Board sets forth standards which must be met in order for a tax benefit to be recognized on the firm's financial statement. Currently, a tax benefit must be ''more likely than not'' to be sustained upon examination in order to be recognized in the corporation's financial reports.[10] Such a determination necessarily requires substantive tax law research and analysis by a tax practitioner. The IRS has classified FIN 48 workpapers as tax accrual workpapers and will treat them the same until they obtain more information about the nature of the workpapers.[11]

Further pressure has also come from Section 404 of the Sarbanes-Oxley Act of 2002, which requires companies to institute effective controls for accounting processes and systems, including those related to tax accounts.[12] This requirement has a significant effect on tax accrual accounting. In 2005, for instance, one of the most frequently cited accounting errors related to deferred taxes.[13] Both companies and their independent auditors are generally responding with more thorough tax accrual workpapers processes and documentation.[14]

These pressures, therefore, result not only in more privileged documents being requested, but in more detailed and in-depth privileged documents being requested.

II. *U.S. v. Textron*: Factual Background

The application of the attorney-client privilege and work-product doctrine was the primary issue addressed in *U.S. v. Textron*.[15] On June 2, 2005, the IRS issued an administrative summons for all of the tax accrual workpapers of Textron Inc. (''Textron'').[16] The IRS had begun examining Textron's 2001 tax return and quickly learned that Textron Financial Corporation (TFC), one of Textron's numerous subsidiaries, had engaged in several sale-in, lease out (SILO) transactions.[17] In February 2005, the IRS defined SILO transactions as a listed transaction under Regs. §1.6011-4T(B)(2).[18] Textron had not disclosed the transactions, so pursuant to the IRS's policy outlined in Announcement 2002-63, the IRS included requests for *all* of Textron's tax accrual workpapers among the more than 500 Information Document Requests it made to Textron.[19] Textron complied with every request except those relating to tax accrual workpapers.[20]

Textron's workpapers consisted of two main elements: (1) spreadsheets containing (a) lists of items on Textron's tax return that in the opinion of counsel may be challenged by the IRS, (b) Textron's estimated chance of prevailing on those issues, and (c) the amount reserved in case Textron did not prevail; and (2) the previous year's spreadsheet and drafts of the spreadsheet with notes and memoranda reflecting the opinion of in-house counsel on each item in the spreadsheet.[21] The court specifically noted that the tax accrual workpapers did not include documents that contained factual information regarding the disputed transactions.[22]

The court also outlined the process by which Textron and TFC's tax accrual workpapers were developed. Each year, Textron's accountants delivered to in-house counsel a copy of the previous year's tax accrual workpapers along with recommendations regarding proposed changes and additions for the current year.[23] In-house counsel reviewed the materials and made further changes which are then given to in-house accountants to calculate the amount of reserve necessary.[24] The attorneys and accountants then met to discuss and determine the final numbers.[25] TFC used a similar process, but instead used outside counsel since it did not have an in-house legal department.[26] The numbers were finally compiled and reported as ''other liabilities'' on Textron's financial statements.[27] The workpapers were subsequently turned over to the independent auditors in order to comply with auditing requirements.[28] Both

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[7] Simmonds and Young, ''Government Loses 'Test Case' on Tax Accrual Workpapers,'' 2007 *Tax Notes Today* 170-1.

[8] 15 U.S.C. §78j-1(a)(1) (2007).

[9] Latham & Watkins, LLP, ''The Auditor's Need For Its Client's Detailed Information vs. The Client's Need To Preserve The Attorney-Client Privilege and Work Product Protection: The Debate, The Problems, and Proposed Solutions,'' at 3 (2004), *available at* http://www.acc.com/public/article/attyclient/debate.pdf

[10] Financial Accounting Standards Board, ''Financial Interpretation No. 48: Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109'' (2006), *available at* http://www.fasb.org/pdf/fin48.pdf

[11] ''Memorandum For Executives, Managers, and Examiners–Large and Mid-Sized Business Division'' (May 10, 2007, LMSB-04-0507-044). *See also*, ''FIN 48 Implications LMSB Field Examiners' Guide'' (May 2007, LMSB-04-0507-045).

[12] Ernst & Young Report, ''Tax Transparency Dynamics and Impact on Clients and Their Advisors,'' reprinted in BNA Tax Core (April 12, 2006).

[13] *Id.*

[14] Latham & Watkins, *supra* note 9, at 4.

[15] *Textron*, 2007 WL 2458325 at *1.

[16] *Id.* at *2.

[17] *Id.*

[18] Notice 2005-13, 2005-9 I.R.B. 630.

[19] *Textron*, 2007 WL 2458325 at *1.

[20] *Id.*

[21] *Id.* at *2.

[22] *Id.*

[23] *Id.* at *3.

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] *Id.*

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Textron and TFC's workpapers were given to the auditors with the explicit understating that they were to remain confidential.[29]

The IRS audited Textron, a large corporation, on a regular basis.[30] Textron also had frequently challenged the IRS's post-audit conclusions.[31] Dating back to 1980, Textron had appealed the determinations reflected in the Revenue Agent's Report in seven of its past eight audit cycles.[32] Three of these disputes were not resolved at Appeals and proceeded to litigation.[33]

III. The Privilege Doctrines

A. The Attorney-Client Privilege

1. Attorney-Client Privilege and Tax Related Work

The attorney-client privilege generally prevents discovery of communications between attorneys and their clients. In order to qualify for protection, the communication must be confidential and made for the purpose of obtaining legal advice. However, as discussed below, disclosure of any significant portion of a confidential communication waives the privilege as to the whole communication.[34]

Documents determining the tax consequences of a transaction are typically covered by the attorney-client privilege.[35] While an attorney preparing a tax return is not performing legal work, analyzing the tax consequences of a transaction is legal in nature, and communications resulting from that work are covered by the attorney-client privilege.[36]

While no independent accountant-client privilege exists,[37] the Code has explicitly created a separate but related privilege for tax practitioners. The tax practitioner-client privilege, contained in §7525, protects confidential communications between a taxpayer and any federally authorized tax practitioner to the same extent that such communications would be privileged if they were between a taxpayer and an attorney.[38] The one significant difference between the two privileges is that the tax practitioner-client privilege does not apply to communications regarding the promotion of corporate tax shelters.[39] Because the breadth of the tax practitioner-client privilege is dependent on the breadth of the attorney-client privilege, this article will focus solely on the attorney-client privilege unless noted otherwise.

2. Tax Accrual Workpapers and Waiver

As mentioned above, when an otherwise privileged document is voluntarily disclosed to a third party, that disclosure typically constitutes a waiver. The court in *U.S. v. El Paso Co.*[40] discussed both the requirements of privilege and waiver in detail. The taxpayer asserted the claim of attorney-client privilege in response to a summons made by the IRS.[41] At issue was the taxpayer's tax accrual workpapers, which contained a summary of the taxpayer's contingent liability for additional taxes.[42] The analysis was prepared by the taxpayer's internal tax department and shared with the independent auditor so that the auditor could fully comply with securities laws.[43] The decision discussed the claimed privilege under both the attorney-client privilege and the work-product doctrine.[44] With respect to the attorney-client privilege, the court determined that the taxpayer's attorney-client privilege was effectively waived because disclosure to a third party destroys confidentiality with respect to a document.[45] Since there is no separate accountant-client privilege, the taxpayer had no grounds for claiming the document was privileged.[46] Most cases addressing this issue have come to the same conclusion.[47]

The attorney-client privilege requires that a communication be confidential in order for it to be protected. Generally, disclosure of any significant portion of a confidential communication to a third-party would violate the confidentiality requirement and thus would waive the privilege as to the whole communication.[48] However, if an attorney were to hire an accountant to help understand complex tax accounting issues arising in a case, any disclosure made to the accountant may be covered under the *Kovel* exception to the waiver rule. This exception applies to communications made by the attorney, or at the request of an attorney, to a third party for the purposes of assisting the attorney and is based on the general principles of agency.[49] Effectively, the third party would be treated as if he were merely translating complex tax and accounting into terms an attorney may understand.[50]

The *Kovel* exception to waiver, however, does not apply in the context of tax accrual workpapers. In order for the exception to apply, the accountant must be performing as an agent of the attorney. As an independent auditor, the accountant is playing an independent role and is not employed to assist the attorney. The independent auditor is only given documents for financial reporting reasons. Therefore, the *Kovel* exception is not applicable and any claim of privilege over documents given to independent auditors is waived.

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[29] *Id.*
[30] *Id.* at *1.
[31] *Id.*
[32] *Id.*
[33] *Id.*
[34] *See U.S. v. El Paso Co.*, 682 F.2d 530, 538 (5th Cir. 1982)
[35] *See, e.g., El Paso Co.*, 682 F.2d at 539 (dictum).
[36] *See U.S. v. Chevron Texaco Corp.*, 241 F. Supp. 2d 1065, 1076 (N.D. Cal. 2002).
[37] *See Arthur Young & Co.*, 465 U.S. at 817.
[38] §7525(a)(1).
[39] §7525(b).
[40] *El Paso Co.*, 682 F.2d at 530.
[41] *Id.* at 533.
[42] *Id.*
[43] *Id.* at 534.
[44] *Id.* at 538.
[45] *Id.* at 540.
[46] *Id.*
[47] *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 229 F.R.D. 441, 444 (S.D.N.Y. 2004) (plaintiff conceded that the attorney-client privilege relating to documents requested by defendant was waived because they were given to an independent auditor). *See also In re Pfizer Inc. Securities Litigation*, 1993 WL 561125, *7 (S.D.N.Y. 1993) (act of giving documents to independent auditor waives attorney-client privilege).
[48] *El Paso Co.*, 682 F.2d at 538.
[49] *U.S. v. Kovel*, 926 F.2d 918 (2d Cir. 1961).
[50] *Kovel*, 926 F.2d at 921.

B. The Work-Product Doctrine

The work-product doctrine has its roots in Federal Rule of Civil Procedure 26(b)(3). Under Rule 26, documents created in anticipation of litigation are not discoverable unless it is shown that there is a substantial need for the materials and the requesting party is unable to obtain substantially equivalent materials.[51] Unlike the attorney-client privilege, work-product protection is not automatically waived upon disclosure of the protected document to a third party. While the attorney-client privilege exists to protect confidential relationships, work-product protection is only intended to protect information from being disclosed to opposing parties in order to promote the adversary system.[52] Accordingly, it does not apply to documents that are prepared in the ordinary course of business or that would have been created irrespective of litigation.[53]

1. The Work-Product Doctrine and Tax Related Work

In the context of tax accrual workpapers and similar documents, the issue normally turns on whether or not the document was prepared in anticipation of litigation. Circuit courts have adopted different standards in determining whether attorney work-product is prepared in anticipation for litigation.[54] The Fifth Circuit has adopted the ''primary purpose'' standard, while many other circuits have adopted the ''because of'' standard.[55] Under both standards it is accepted that litigation need not have been commenced for the work-product doctrine to apply. In explaining the stricter primary purpose standard, the Fifth Circuit stated in *U.S. v. Davis* that ''litigation need not be imminent . . . so long as the primary motivating purpose behind the creation of the document was to aid in possible future litigation.''[56]

a. The "Primary Purpose" Standard

The primary purpose standard only provides work-product protection to documents prepared in anticipation of litigation ''as long as the primary motivating purpose behind the creation of a document was to aid in possible future litigation.''[57]

The Fifth Circuit has addressed the primary purpose standard in the context of tax related work-product on several occasions.[58] In *U.S. v. Davis*, two types of documents were requested in a summons enforcement proceeding: (1) records pertaining to financial transactions for the years at issue; and (2) workpapers generated by Davis, a licensed attorney who served as the accountant for the taxpayer, and his co-worker for his own use in the preparation of the taxpayer's tax return.[59] The financial transaction documents were not given work-product protection because they were prepared by the client, rather than by or on behalf of an attorney.[60] In regard to the tax preparation documents, the court held that the work done in connection with preparing a tax return was *not* primarily motivated to assist in future litigation.[61] Specifically, ''papers generated by an attorney who prepares a tax return are not within the work-product privilege simply because there is always a possibility that the IRS might challenge a given return.''[62] While noting that litigation need not be imminent, the court also found that ''there is no evidence that Davis had reason to expect future trouble with the IRS. Davis's workpapers were to aid in preparing tax returns, not primarily to help litigate over those returns.''[63]

More recently, the Fifth circuit held in *U.S. v. El Paso Co.* that tax accrual workpapers[64] were primarily prepared to meet financial reporting requirements rather than prepare for litigation.[65] The specific workpapers requested contained an analysis forecasting the cumulative results of any potential IRS audit, settlement, and potential litigation, but were not prepared to respond to a specific charge by the IRS or to any impending lawsuit.[66] The workpapers were prepared in-house after the tax return had already been filed and for the purpose of financial reporting requirements and were given to the company's independent auditors to ensure that the corporation's balance sheet had set aside a sufficient amount to cover contingent tax liability.[67] While some of the conclusions contained in the workpapers were derived through legal analysis, the court held that the analysis was only a means to an end.[68] The primary purpose of the workpapers was for financial reporting purposes and therefore the court decided the documents were not protected by the work-product doctrine.[69] Specifically, the court noted that ''no single item in the [workpapers] [was] specifically under scrutiny by the IRS when the memoranda [were] drafted'' and ''[b]usiness imperatives, not the press of litigation, call these documents into being.''[70]

The ''primary purpose'' standard was also adopted in *U.S. v. Gulf Oil Co.*[71] Similar to *El Paso Co.*, the court held that letters sent to an auditor to provide an update on the status of litigation were not protected by the work-product doctrine because they were created primarily for the business purpose of compiling financial statements to satisfy federal securities laws.[72] The independent auditor requested the information to complete its annual audit and the letter was drafted by the law firm specifically to update the auditor. While the letter contained legal arguments, its purpose was not to aid in litigation, but rather to inform the auditor of potential

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[51] Fed. R. Civ. Proc. 26.
[52] *See Gulf Oil Co.*, 760 F.2d at 295.
[53] *U.S. v. Adlman*, 134 F.3d 1194, 1202 (2d Cir. 1998).
[54] *Compare U.S. v. Roxworthy*, 457 F.3d 590, 593 (6th Cir. 2006), *with U.S. v. Davis*, 636 F.2d 1028, 1040 (5th Cir. 1981).
[55] *Id.*
[56] *Davis*, 636 F.2d at 1040.
[57] *El Paso Co.*, 682 F.2d at 542.
[58] *See, e.g., Davis*, 636 F.2d 1028; *El Paso Co.*, 682 F.2d 530.
[59] *Davis*, 626 F.2d at 1032.
[60] *Id.* at 1040.
[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] The court actually referred to the documents as a tax pool analysis, but also stated that the names are interchangeable. *El Paso Co.* 682 F.2d at 544.
[65] *Id.* at 543.
[66] *Id.* at 544.
[67] *Id.* at 534.
[68] *Id* at 534, 543.
[69] *Id.* at 543.
[70] *Id.*
[71] *U.S. v. Gulf Oil Co* , 760 F.2d 292 (Temp. Emer. Ct. App. 1985).
[72] *Id.* at 527.

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tax liability.[73] The letter therefore was not afforded work-product protection.

b. The "Because of" Standard

Many other circuits have adopted a slightly broader interpretation of the phrase ''in anticipation of litigation.'' Most circuits have followed Wright and Miller's *Federal Practice and Procedures* in interpreting the phrase to mean ''prepared or obtained *because of* litigation.''[74] The ''because of'' standard is broader because it requires only that the work product be created in reasonable anticipation of litigation, regardless of the primary purpose of the document.

The Second Circuit provided an excellent articulation of the ''because of'' standard in *U.S. v. Adlman*.[75] It stated:

> [A] document . . . does not lose work-product protection merely because it is intended to assist in the making of a business decision influenced by the likely outcome of the anticipated litigation. Where a document was created because of anticipated litigation, and would not have been prepared in substantially similar form but for the prospect of that litigation, it falls within Rule 23(b)(3).[76]

In *Adlman*, the taxpayer had an accountant and lawyer from Arthur Anderson evaluate the tax consequences of a proposed restructuring. The resulting tax opinion offered detailed legal analysis, recommended preferred methods of structuring, and made predictions about the likely outcome of the litigation.[77] The court found that litigation was virtually certain for a number of reasons. Specifically, the court noted that the taxpayer was audited annually, the refund requested was so large that the IRS was required by law to submit a report to the Joint Committee on Taxation, and the restructuring was based on an interpretation that did not have any authority directly on point.[78] The court also explicitly rejected the ''primary purpose'' test adopted by other circuits and found there was no textual support for such an interpretation of Rule 23(b)(3).[79] The court remanded the case with instructions that the document should be protected unless it was shown that the document would have been prepared in any event as part of the ordinary course of business.[80]

In *U.S. v. Roxworthy*, the Sixth Circuit also interpreted the ''because of'' standard to mean that a tax opinion could be prepared in anticipation of litigation.[81] The IRS sought tax opinions prepared by KPMG which analyzed the tax consequences of a transaction entered into by the taxpayer. The opinions included likely arguments that the IRS would mount against the taxpayer as well as potential counter-arguments.[82] The court stated that the ''because of'' test requires that a party have a subjective belief that litigation is a real possibility, and that the belief is objectively reasonable.[83] To meet the objective element, the taxpayer pointed to litigation commenced by the IRS in factually analogous cases and the fact that an audit was certain due to the company's size.[84] The court found that the taxpayer's anticipation of litigation was not too remote to be considered unreasonable.[85] The taxpayer submitted affidavits to demonstrate the subjective element.[86]

The Sixth Circuit also found that the magistrate judge erroneously assumed that the use of the tax opinion for the audit process precluded the assertion of the work-product privilege.[87] The court noted that a document can be created both in anticipation of litigation and for use in the ordinary course of business without losing its work-product privilege.[88] Accordingly, the Sixth Circuit found the district court's decision to adopt the magistrate judge's findings clearly erroneous and reversed the district court's order granting the IRS's summons enforcement petition.

c. Conclusion

Both tax accrual workpapers and other tax documents appear to be covered by the work-product doctrine under the ''because of'' standard. However, the result is less clear under the ''primary purpose'' standard. Under Fifth Circuit precedent, tax accrual workpapers have not been protected under the ''primary purpose'' standard. It is also unclear whether a tax opinion or other tax-related documents would be covered by the work-product doctrine under the ''primary purpose'' standard.

2. Waiver of Work-Product Protection

Like the attorney-client privilege, the work-product doctrine may also be waived by disclosure to a third party. However, unlike the attorney-client privilege, the work-product doctrine is not automatically waived upon such a disclosure. Because the work-product doctrine is founded on a policy of adversarial fairness, work-product protection is lost only when a disclosure substantially increases the possibility that an adverse party could obtain the information.[89] This test was applied in *U.S. v. Gulf Oil Co.*, where the court held that work-product protection was not waived when documents were disclosed pursuant to a merger agreement

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[73] *Id. See also Beal v. Treasure Chest Casino*, 1999 WL 461970 (E.D. La. 1999) (letter sent by insurance adjuster to an attorney asking how to classify a claim was not protected because it was created for insurance classification purposes and not litigation).

[74] *See, e.g., Roxworthy*, 457 F.3d at 593 (emphasis added); *accord Maine v. Dep't of the Interior*, 298 F.3d 60, 68 (1st Cir. 2002); *U.S. v. Adlman*, 134 F.3d 1194, 1202 (2d Cir. 1998); *Nat'l Fire Ins. Co. of Pittsburgh v. Murray Sheet Metal Co.*, 967 F.2d 980, 984 (4th Cir. 1992); *Binks Mfg. Co. v. Nat'l Presto Indus., Inc.*, 709 F.2d 1109, 1119 (7th Cir. 1983); *In re Grand Jury Proceedings*, 604 F.2d 798, 803 (3d Cir. 1979).

[75] *Adlman*, 134 F.3d at 1194.

[76] *Id.* at 1195.

[77] *Id.*

[78] *Id.* at 1197.

[79] *Id.* at 1198.

[80] *Id.* at 1204.

[81] *Roxworthy*, 457 F.3d at 600.

[82] *Id.* at 592.

[83] *Id.* at 594.

[84] *Id.* at 600.

[85] *Id.*

[86] Despite the affidavits, the magistrate judge had found that the subjective element was lacking in part due to the fact that the tax opinion was not written until after the transaction was completed. However, the circuit court held that this decision could easily lead to the opposite conclusion that the opinion was more likely to be in anticipation of litigation. *Id.* at 597.

[87] *Id.* at 598-99.

[88] *Id.* at 599.

[89] *GAF Corp. v. Eastman Kodak Co.*, 85 F.R.D. 46, 51-52 (S.D.N.Y. 1979) (citing 8 Wright & Miller §2024 at 210)

because the parties were not adversaries at the time of the disclosure.[90] This standard has been adopted by other circuits addressing waiver.[91]

The most relevant authority on whether disclosure to an independent auditor constitutes a waiver comes from the Southern District of New York. In *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, the plaintiff's in-house attorneys produced two reports in response to litigation arising from thefts.[92] The reports were the result of an internal investigation into the thefts and were otherwise covered by the work-product doctrine.[93] After they were compiled, the reports were disclosed to plaintiff's independent auditor to notify them of any accounting or audit issues that the auditor may not have been aware of.[94] They were disclosed to the auditor with the understanding that they were privileged and confidential.[95] The court noted that:

> Tension between an auditor and a corporation that arises from an auditor's need to scrutinize and investigate a corporation's records and book-keeping practices is not the equivalent of an adversarial relationship contemplated by the work-product doctrine. Nor should it be. A business and its auditor can and should be aligned insofar as they both seek to prevent, detect, and root out corporate fraud. Indeed, this is precisely the type of limited alliance that courts should encourage.[96]

Importantly, the auditor also did not disclose the privileged materials to any additional parties.[97] In fact, the court noted that the auditor was under ethical and professional obligation to maintain the confidentiality of the materials received.[98] At worst, the auditor would have disclosed only that it was unable to accurately evaluate the taxpayer's financial statements due to internal-control deficiencies.[99] Under these facts, the court concluded that the work-product doctrine had not been waived.[100]

The Southern District of New York reached the same conclusion in *In re Pfizer Inc. Sec. Litig.*[101] Documents created pursuant to an effort to monitor reserves for heart valve litigation were subsequently used by the legal department to develop litigation strategies.[102] The documents were later given to an independent auditor.[103] The court found that the company and the auditor ''obviously shared common interests in the information, and [the auditor] is not reasonably viewed as a conduit to a potential adversary.''[104] Accordingly, the court found work-product protection was not waived upon disclosure to the independent auditor.[105]

While this approach has been used in other jurisdictions,[106] courts have not reached a uniform conclusion regarding disclosures to independent auditors. Prior to *Pfizer*, the Southern District of New York had found a waiver of work-product protection under similar facts. In *Medinol, Ltd. v. Boston Scientific Corp.*,[107] work-product protection was waived because the court found the interests of an auditor are not aligned with the company and therefore the disclosures did not serve the privacy interest the work-product doctrine was intended to protect. The court in *Merrill Lynch & Co.* explicitly distinguished *Medinol* by noting that, while an independent auditor could be an adversary, it was not an adversary under the facts of the case.[108]

The *Merrill Lynch & Co.* court also cited *U.S. v. Massachusetts Institute of Technology* (M.I.T.) as an example of how disclosure to an external auditor can waive work-product protection.[109] In *M.I.T.*, documents were disclosed to the Department of Defense's audit agency.[110] The court considered the auditor an adversary because it had the ability to dispute a billing charge.[111]

As noted in the *Textron* decision, many other courts addressing disclosures to independent auditors have reached the same conclusion.[112] The growing consensus, therefore, supports the conclusion that disclosure to an independent auditor does not waive work-product protection.

IV. *U.S. v. Textron*: Decision and Analysis

A. The Court's Decision

1. The Attorney-Client Privilege

The court's decision in *Textron* primarily addressed the application of the attorney-client privilege and

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[90] *Gulf Oil Co*, 760 F.2d at 296.

[91] *See, e.g.*, *In re Grand Jury Subpoena*, 220 F.3d 406 (5th Cir. 2000); *U.S. v. American Tel. & Tel. Co.*, 642 F.2d 1285 (D.C. Cir. 1980).

[92] *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 229 F.R.D. 441, 444 (S.D.N.Y. 2004)

[93] *Id*.

[94] *Id*.

[95] *Id*.

[96] *Id.* at 448.

[97] *Id.*

[98] *Id.*

[99] *Id*. at 448-449.

[100] *Id.* at 449.

[101] *Pfizer Inc.*, 1993 WL 561125 at *6 (S.D.N.Y. 1993).

[102] *Id.* at *3.

[103] *Id.* at *6.

[104] *Id.*

[105] *Id.*

[106] In *Raytheon Sec. Litig.*, 218 F.R.D. 354 (D. Mass. 2003), the court took a similar approach to resolving the waiver issue concerning audit opinion letters developed in-house that were disclosed to an independent auditor. *Id.* at 356. Unlike *Merrill Lynch & Co.*, the court in *Raytheon* did not come to an ultimate decision of whether or not there was a waiver of the work product doctrine. However, the court analyzed the issue in the same manner and ordered the parties to produce documents demonstrating to what extent an independent auditor can reasonably be expected to disclose protected information through public financial reports. *Id.* at 361.

[107] *Medinol, Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113, 115 (S.D.N.Y. 2002)

[108] *Merrill Lynch & Co.*, 229 F.R.D. at 446.

[109] *Id*.

[110] *U.S. v. Massachusetts Institute of Technology*, 129 F.3d 681, 687 (1st Cir. 1997).

[111] *Id*.

[112] *In re JDS Uniphase Corp. Sec. Litig.*, 2006 WL 2850049 (N.D. Cal. 2006) (board minutes disclosed to the independent auditor); *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc.*, 237 F.R.D. 176 (N.D. Ill. 2006) (''[d]isclosing documents to an auditor does not substantially increase the opportunity for potential adversaries to obtain the information.''); *Frank Betz Assocs., Inc. v. Jim Walter Homes Inc.*, 226 F.R.D. 533, 535 (D.S.C. 2005) (disclosure of documents supporting reserve for copyright infringement litigation); *Gutter*, 1998 WL 2017926 *5, *3 (S.D. Fl. 1998) (disclosure to auditor of letters estimating cost of litigation).

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work-product doctrine to Textron's tax accrual workpapers. When addressing the attorney-client privilege the court first concluded that while the attorney-client privilege covered the documents requested by the IRS, that privilege was waived when the documents were given to Textron's independent auditors.[113] The IRS had attempted to argue that the documents did not constitute legal advice in the first place and therefore were not within the scope of the attorney-client privilege at all.[114] The court quickly disposed of that argument, concluding that the tax accrual workpapers of both Textron and TFC consisted entirely of counsel's opinion regarding items that might be challenged because they involved areas of unsettled law.[115] Such work, the court concluded, was legal work and thus within the scope of the attorney-client privilege.[116] Later in the opinion, the court held that, while the workpapers were covered by the attorney-client privilege, the privilege was waived when the documents were disclosed to Textron's auditors.[117] The court cited a long line of decisions supporting this position and quickly moved on.[118]

Textron did assert an innovative argument against waiver. Textron stated that since it occasionally revises its reserve amounts based on the auditor's opinion, the documents should be privileged under §7525 as ''tax advice.''[119] The court held that while creative, the argument ''ignores reality to describe an independent auditor . . . as providing 'tax advice' to the company when the auditor seeks to determine the adequacy of amounts reserved by the company for contingent tax liabilities.''[120]

2. The Work-Product Doctrine

The court's discussion of the work-product doctrine was more complex. The court initially recognized the circuit split regarding the ''in anticipation of litigation'' requirement, before applying the ''because of'' standard as adopted by the First Circuit.[121] Under the ''because of'' standard, the court held that Textron's tax accrual workpapers were protected by the work-product doctrine.[122] While the IRS argued that the documents were created in the ordinary course of business and therefore were not protected, the court concluded that the documents would not have been prepared ''but for'' the prospect of litigation and therefore fell within the scope of the doctrine.[123] Specifically, the court noted ''[i]f Textron had not anticipated a dispute with the IRS, there would have been no reason . . . to prepare the workpapers used to calculate the reserve . . . There would have been no need to create a reserve in the first place.''[124] Textron's history of tax litigation and administrative appeals also gave the corporation sufficient support for their belief in the prospect of litigation.[125] Contrary to the conclusion reached in *El Paso Co.*, where the court applied the ''primary purpose'' standard, the *Textron* court concluded that the work-product doctrine may apply even though the documents were created for financial reporting purposes.[126]

After determining that the work-product doctrine was applicable, the court continued to discuss whether such protection was waived upon disclosure of the tax accrual workpapers to Textron's independent auditor. Unlike the attorney-client privilege, the policy behind the work-product doctrine states that only disclosures ''that are inconsistent with keeping the information from an adversary constitute a waiver of the work product privilege.''[127] Citing a multitude of cases reaching the same conclusion,[128] the court found that work-product protection was not waived upon disclosure to an independent auditor because the disclosure did not ''substantially increase the IRS's opportunity to obtain the information contained in them.''[129] Under AICPA Code of Professional Conduct Section 301, the independent auditor also had a duty not to disclose confidential information without Textron's consent.[130] Furthermore, the documents were given to the independent auditor with the understanding that they were confidential.[131] Combined, these factors outweighed the IRS's argument for waiver. As in *Merrill Lynch & Co.*, the court distinguished *M.I.T.* because the auditor in *M.I.T.*, unlike the independent auditor involved in *Textron*, was a potential adversary.[132] After the decision was announced, the IRS continued to assert that the *M.I.T.* decision supports its position.[133]

Finally, while work-product protection may be overcome by a showing that there is substantial need for the documents and an inability to otherwise obtain the documents, the court held that such a showing was not made by the IRS.[134] The documents had little connection to the determination of Textron's tax liability since ''[t]he determination of any tax owed by Textron must be based on *factual* information, none of which is contained in the workpapers and all of which is readily available to the IRS through the issuance of IDRs and by other means.''[135] The court finally noted that forced disclosure of tax accrual workpapers ''would put Textron at an unfair disadvantage in any dispute that might arise with the IRS.''[136]

B. Analysis

The *Textron* decision was important for a number of reasons. First, the factual posture of the case meant that it was decided under unique circumstances with much at stake. Second, the substantive decisions concerning

[113] *Textron*. 2007 WL 2458325 at *6, *12.
[114] *Id.* at *5.
[115] *Id.* at *6.
[116] *Id.*
[117] Transcript of Proceedings (Evidentiary Hearing) held on June 26, 2007 at 50, *U.S. v. Textron, Inc.*, No. 06-198 (D.R.I. Aug. 28, 2007).
[118] *Id.* at *11.
[119] *Id.* at *11.
[120] *Id.*
[121] *Id.* at *9.
[122] *Id.* at *10.
[123] *Id.*
[124] *Id.*
[125] *Id.*
[126] *Id.*
[127] *Id.* at *12.
[128] *Id.* For a list of the cases, *see supra* note 112.
[129] *Id.* at *13.
[130] *Id.*
[131] *Id.*
[132] *Id.*
[133] Herzfeld, ''Korb Criticizes Textron Decision; No Decision Made on Whether to Appeal,'' *BNA White Collar Crime Report*, Oct. 12, 2007, at 614.
[134] *Id.* at *14.
[135] *Id.* (emphasis original).
[136] *Id.*

the attorney-client privilege and work-product doctrine continued to shape an unsettled area of law. Finally, the court's policy discussion provided further support for the position that tax accrual workpapers should be protected from forced disclosure to the IRS.

1. Factual Posture

While the IRS has requested tax accrual workpapers in the past, this is one case where it requested *all* of the taxpayer's tax accrual workpapers. If Textron had been forced to disclose all of their workpapers, they would have given the IRS a list of every transaction in which they had calculated potential liability. This blueprint would serve as a quick guide to where the IRS should focus its auditing efforts. In the past, where the tax accrual workpapers for the transaction in question where requested, such a widespread disadvantage was not at issue. Had the IRS's request been narrower, the court may have found more sympathy for their argument.

The facts also assisted the taxpayer's case. According to the court, Textron's tax accrual workpapers contained no additional factual information. Had additional information been contained in the documents, the IRS may have been able to overcome the work-product protection by showing a stronger need for the documents. Furthermore, Textron disclosed the documents to the independent auditor with the understanding that the documents were to remain confidential. The latter fact was listed by the court among many reasons why the disclosure did not waive work-product protection. The court may have reached a different result if the documents were not disclosed under those circumstances.

2. Substantive Law

The substantive analysis can be divided into two parts. The court's decision regarding the attorney-client privilege reiterated the current state of the law. The court's decision regarding the work-product doctrine, on the other hand, addressed an unsettled area of law.

The decision's substantive holding continued to support a line of cases declining to protect previously disclosed tax accrual workpapers under the attorney-client privilege. The IRS continues to argue that tax accrual workpapers do not constitute legal work and are therefore not within the scope of the attorney-client privilege. This argument again proved unsuccessful. The court also adopted a strict adherence to the waiver doctrine and did not protect the tax accrual workpapers under the attorney-client privilege since the documents were disclosed to an independent auditor. As mentioned earlier, the vast majority of courts considering the issue have also reached this same conclusion. This case demonstrates again that such an argument would struggle to find sympathy in federal court.

Textron's argument that it was seeking tax advice from the independent auditor was also without merit. While Textron could adjust their reserve amounts after speaking with the auditors it was not the auditor's tax advice that was sought. Textron's argument was creative and original, but it was not supported by testimony at the evidentiary hearing and Textron even testified that they did not receive a copy of the independent auditor's papers, documents, or analyses.[137]

The court's holdings regarding the work-product doctrine were even more significant. The court concluded that the tax accrual workpapers were prepared in anticipation of litigation even through they were also prepared to meet financial reporting obligations. The court was very sympathetic to the taxpayer's case and used its well-reasoned opinion to provide strong support for the argument that the doctrine supports the protection of tax accrual workpapers. The decision became one of many recent decisions that run counter to the holding in *El Paso Co*.

While the court did not discuss this issue, the facts in *Textron* also support a scenario in which tax accrual workpapers might be protected under the stricter ''primary purpose'' test used in *El Paso Co*. In the evidentiary hearing, Textron's Vice President of Taxes stated that, in the absence of financial reporting obligations, tax accrual workpapers would still be generated because ''it would guide [Textron] in making litigation and settlement decisions later in the process.''[138] If such testimony were accepted by the trier of fact, it could support a conclusion that the primary motivating purpose behind the creation of a document may have been to aid in future litigation, thereby meeting the primary purpose standard as outlined in *El Paso Co*.

The most unsettled area of law concerns whether or not disclosure to an independent accounting firm waives work-product protection. *Textron* follows other recent cases in concluding that such a disclosure does not constitute a waiver since the independent auditor's interests are not adverse to the corporation's. As in other cases, the court noted the significance of the fact that independent auditors have professional obligations to maintain the confidentiality of auditing materials. Furthermore, the court found it significant that the documents were disclosed to the independent auditor with the understanding that the documents were privileged. Both elements will likely continue to play an important role in any future court's analysis of the issue.

Finally, the decision may provide support for the protection of related tax documents such as FIN 48 workpapers and tax opinions. As mentioned above, the IRS plans to treat FIN 48 workpapers as tax accrual workpapers. Similar reasoning may be used to argue that FIN 48 workpapers are also protected by the work-product doctrine as they are created for similar reasons and under similar circumstances. This may be important as the IRS has stated FIN 48 ''should be considered by examiners and others when conducting risk assessments.''[139] FIN 48 disclosures have already led to Senate investigations of at least 30 companies, and the IRS will likely follow suit bringing the issue of FIN 48 workpapers to the forefront.[140]

A tax opinion disclosed to an independent auditor may also find greater support for protection under *Textron*. Like tax accrual workpapers, the fate of disclosed tax opinions is in a state of uncertainty. The reasoning of the opinion may be used to support a stronger argument concerning tax opinions, even under the ''primary purpose'' standard. Unlike tax accrual workpapers, tax opinions are not required by financial reporting obligations and are primarily used to analyze the legal conse-

[137] Transcript, *supra* note 11, at 50.

[138] Transcript, *supra* note 11, at 51.

[139] *Memorandum For Executives*, *supra* note 12.

[140] Drucker, ''How Accounting Rule Led to Probe,'' *Wall St. J.*, Sept. 11, 2007, at A5.

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quences of a transaction. Even the titles of the categories of opinions (e.g. ''more likely than not,'' ''should,'' etc.) refer to the prospect of liability and litigation. If an unfavorable opinion is obtained, corporations will often restructure a transaction to avoid potential litigation or increase the probability of prevailing if litigated. All these facts demonstrate that the principle reason an opinion is created is not due to business imperatives, but due to the press of legal liability and potential litigation.

3. Policy Implications

Even before the decision was released, tax litigators were keeping a close eye on the *Textron* case. However, the decision will likely gain more credibility due to its coherent and well-reasoned opinion. Judge Torres used a combination of precedent and strong policy arguments to support his decision.

Several competing policies must be balanced when determining whether the IRS should be allowed access to tax accrual workpapers. The U.S. Supreme Court has reiterated that the attorney-client privilege is intended promote ''full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and the administration of justice.''[141] As the Third Circuit has noted, unless the disclosure serves the purpose of enabling the clients to obtain legal advice, such a disclosure is not consistent with the policy of the privilege.[142] With regard to the work-product doctrine, the fairness of litigation must be weighed heavily. On the other hand, as pointed out by the *Textron* court, Congress has made a policy choice in favor of disclosure of all information relevant to a legitimate IRS inquiry for the purposes of tax investigations.[143]

Since disclosure to the independent auditor did not involve an attorney, the attorney-client privilege was not really at issue and the policy debate focused on the work-product doctrine. The decision mentioned at several points that Textron's tax accrual workpapers did not contain any additional facts. The workpapers only contained legal material and therefore disclosure would unfairly disadvantage Textron in any future dispute, and also would not provide the IRS with any additional facts to conduct their investigation. Importantly, the court noted that this outcome would be patently unfair ''just as requiring the IRS to disclose the opinions of its counsel regarding areas of uncertainty in the law or the likely outcome of any litigation with Textron would place the IRS at an unfair disadvantage.''[144] Disclosing documents to an independent auditor is required and does not increase the chance that the opposing party will obtain the information. Due to the obligations to maintain confidentiality and the circumstances in which the disclosure was made, such a disclosure cannot be equated with disclosure to an adverse party.

The decision is also consistent with the current political climate. By adopting a broad interpretation of the work-product doctrine, the court not only protected the tax accrual workpapers from forced disclosure to the IRS, but also likely promoted communication between corporations and their independent auditors. If the documents were not protected under either the attorney-client privilege or the work-product doctrine, communication with independent auditors would either be discouraged or the IRS would gain an unfair advantage. To the extent the IRS forces its position, the former result is more likely. In the wake of the Sarbanes-Oxley Act of 2002, there is a strong political pressure to promote full and frank communication between corporations and their independent auditors to avoid future accounting scandals. By providing confidentiality to those communications, the *Textron* decision further promotes such communication.

V. Conclusion

With the current pressures on independent auditors and in-house tax departments, the *Textron* decision will be used as guidance in interpreting the extent of privilege relating to previously disclosed tax documents. A strong body of precedent now supports the protection of disclosed tax accrual workpapers and related documents under the work-product doctrine. Furthermore, such protection is not waived when the documents are disclosed to an independent auditor, since the auditor is does not have an adverse interest. Nevertheless, the issue is far from settled. Chief Counsel Donald Korb has indicated that the IRS is ''not going to change anything as a result of this decisions.''[145] In the face of an approaching deadline, the IRS recently filed a notice of appeal.[146] However, an IRS spokeswoman indicated the notice was intended as a placeholder that will protect the government's right to appeal the decision.[147] In any case, the impact of the decision will be significant as courts continue to grapple with this issue.

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[141] *Swindler & Berlin v. U.S.*, 524 U.S. 399, 403 (1998).

[142] *Westinghouse Electric Corp. v. Republic of the Philippines*, 951 F.2d at 1414, 1425 (3d Cir. 1991).

[143] *Textron*, 2007 WL 2458325 at *3 (*See Arthur Young & Co.*, 465 U.S. at 816).

[144] *Id*. at *14.

[145] ''Korb Says Government Unlikely to Yield On Textron; Practitioners Praise Court Ruling, ''BNA Daily Tax Report,'' Aug. 31, 2007, at K-1.

[146] *U.S. v. Textron, Inc.*, No. 06-198, *Notice of Appeal filed* (D.R.I. 10/22/07).

[147] ''Government Files Notice it is Appealing Textron Work Product Privilege Ruling,'' Daily Tax Report (BNA), Sept. 24, 2007, p. K-1.